LGT CAPITAL PARTNERS

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Inflation-linked bonds

A "real" diversifier for long-term investors

Marketing material

A brief introduction to the asset class

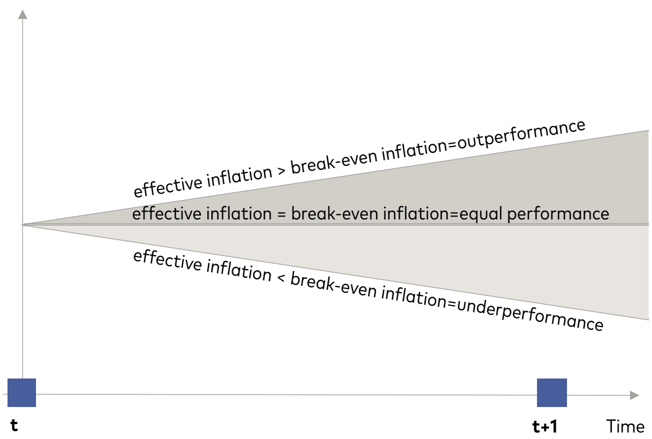
Inflation-linked bonds ("linkers") are securities that aim to protect investors against inflation risks in their portfolio. Because payouts are effectively linked to an official inflation index, linkers are well positioned to offer sustainable protection against loss of purchasing power due to higher-than-expected inflation. Even when inflation rates are high, the asset class can preserve its real returns because payouts and redemptions are adjusted for purchasing power. Since linkers react differently to changing economic circumstances than other asset classes, they also offer diversification benefits in the broader portfolio context. Inflation-linked bonds are a very effective component of any long-term fixed income portfolio for institutional investors such as pension funds or insurers, since locking in inflation-linked cash flows helps them to offset liabilities that are often also indexed to inflation.

Key characteristics

- Inflation protection: Linkers provide inflation compensation. The capital value of the bonds to which real coupons are attached is continuously indexed to adjusted inflation. That capital value determines the repayment amount. If the official inflation index (e.g. the consumer price index; CPI) increases by 2%, the capital value of the bonds–and consequently all payment flows–also increase by 2%, ensuring that the purchasing power of the invested capital is maintained.

- Breakeven rates: When comparing the expected performance of nominal government bonds and inflation-linked bonds, it is important to consider the main return drivers of each type of instrument. Nominal bond yields comprise two components: the real interest rate and breakeven inflation. The latter indicates the market's expected average annual inflation rate at which nominal and real bonds (with otherwise identical characteristics, e.g. issuer, currency and maturity) will generate the same return. If realized inflation is higher than indicated by breakeven inflation at the time of analysis, the inflation-linked bond should outperform. If it is lower, the nominal bond should outperform.

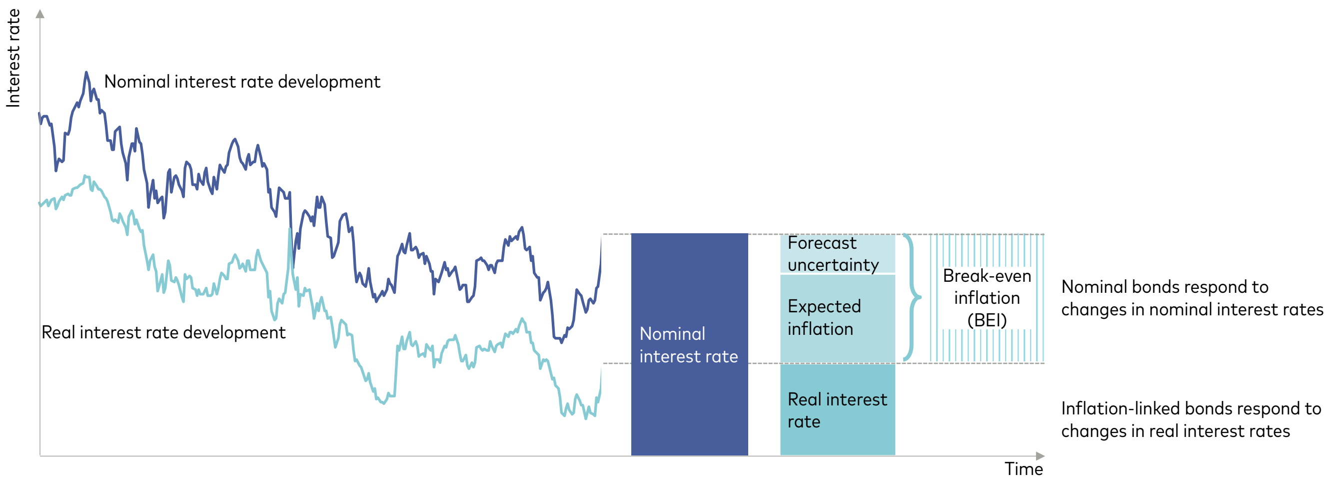
Performance comparison in various inflation scenarios



Source: LGT Capital Partners
If the effective occurred inflation is underestimated, the performance of inflation-linked instruments is higher. If the inflation is overestimated, the performance of nominal bonds is higher. This data is purely indicative and is not a guarantee of future results.

- Diversification: The changing inflation outlook is directly reflected in bond markets in terms of breakeven inflation and consequently also the relative performance of nominal and inflation-linked bonds. Linkers have historically performed better than comparable nominal government bonds when inflation has risen, and the same is true when inflation expectations increase. Bond investors can therefore improve the risk-return profile of their portfolio by replacing part of their nominal bonds with inflation-linked bonds, as linkers and nominal government bonds react differently to economic developments and are not fully correlated.
- Deflation floor: In the event of a prolonged period of deflation during the overall term of the bond, the issuer will repay at least the full par amount at maturity. The bonds of most issuing countries include this feature and therefore offer this asymmetric risk component.

Components of the nominal interest rate



Source: LGT Capital Partners
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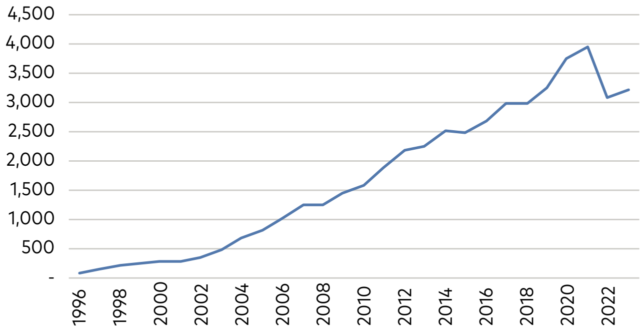
Recent developments in the inflation-linked bond market

The global market size for linkers from 12 developed countries was USD 3,221.87 billion at the end of 2023. Its market capitalization has therefore more than doubled over the past 15 years.

Inflation-linked bond market capitalization in USDm



Source: LGT Capital Partners

The inflation-linked bond market experienced a brief decline in value in 2022 due to a strong rise in yields but its market capitalization has since increased. Canada and Germany recently announced their withdrawal from the inflation-linked bond market, with officials attributing the decision to the lack of liquidity and to the high costs for issuers. In Germany, the annual issuance volume of linkers amounted to only 1% of the average annual issuance volume of all federal securities for the last two years. In Canada, the real return bond market has been relatively illiquid, with only eight outstanding bonds and mainly very long maturities, as demand outstripped supply.

Inflation-linked bonds give a market-based measure of inflation expectations and thus serve a vital function for markets and the governments that issue those bonds. We do not currently believe that more countries will follow Germany and Canada in exiting this market, as the use of linkers demonstrates the commitment of governments to keeping inflation under control. In addition, these instruments enable governments to access the financial market in an unfavorable environment for fixed income and to lower debt-servicing costs. Despite this move by Germany and Canada, the impact on market capitalization and liquidity has been negligible as instruments with long maturities that were issued by the two countries will remain in the global investment universe for more than another decade.

In 2022, France issued its first sovereign green inflation-linked bond indexed to the European Harmonized Index of Consumer Prices (HICP) (excluding tobacco). This makes France the first mover in this niche area. In May 2024, the US announced that the Treasury is considering the sale of green bonds, with the proposed new securities potentially also including inflation-linked bonds.

We strongly believe in the need for climate action, and we support the green transition but we also recognize that achieving this goal will come at a cost. To disincentivize the use of fossil fuels, it is likely that higher taxes will be imposed on these energy sources, which may result in higher energy prices. The need for new investments in green energy production may also lead to higher prices in the near or medium term. This could temporarily create a supply/demand imbalance. This type of scenario would further enhance the attractiveness of linkers over the medium to long term.

Finally, we consider it likely that the increasing frequency of extreme weather events around the globe will drive up prices, with the cost of food and transportation services being particularly affected.

Performance of inflation-linked bonds since the Covid pandemic–short duration was a key differentiator to achieve both positive absolute and relative returns

Many investors' portfolios are traditionally dominated by a mix of equities or equity-like asset classes as well as nominal bonds (government and corporate). Equity investments tend to perform favorably in a disinflationary growth environment. This means that they benefit from good growth prospects and low to falling inflationary pressure. Nominal bonds tend to perform particularly well in a deflationary environment, i.e. when the growth outlook becomes gloomier and inflation–and thus also interest rate expectations–decline. In terms of increasing or decreasing economic growth, equities and bonds behave in opposite ways, which is why a combination of the two assets can help to diversify portfolios in terms of growth. What both asset classes have in common, however, is that they tend to benefit from falling inflation, while rising inflationary pressure has a negative impact on their performance, all other things being equal.

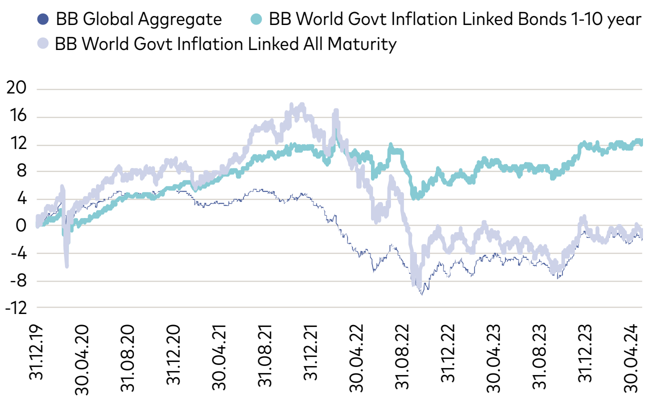
This is precisely where the uniqueness and added value of inflation-linked bonds comes into play. Linkers, unlike equities and nominal bonds, benefit from rising inflation rates. The asset class therefore offers protection against inflation risk. Their inflation protection feature results from the fact that their capital value is linked to an official inflation index, meaning that both the coupons and the capital repayments rise in line with inflation. Linkers thus tend to perform well in both environments that are disadvantageous for equities (low growth, high inflation), and they perform better than conventional bonds when inflation rises.

For global investors, there are generally two investment approaches available in the market for inflation-linked bonds based on the available indices, which provide a choice of maturity buckets:

- Bloomberg World Government Inflation-Linked Bonds 1–10 Years
- Bloomberg World Government Inflation-Linked All Maturities

Linkers have been tested across various economic market cycles and during the recent inflationary environment. When the Covid pandemic began, linkers performed exactly as intended. The key factor determining portfolio performance for investors was the choice of interest rate sensitivity in their investment portfolios. As outlined in chart 1 below, the Bloomberg World Government Inflation-Linked Bond Index 1–10 Years had a positive total absolute return overall and has significantly outperformed both the Bloomberg Global Aggregate (nominal bond index) as well as the Bloomberg World Government Inflation-Linked All Maturities since the beginning of 2020.

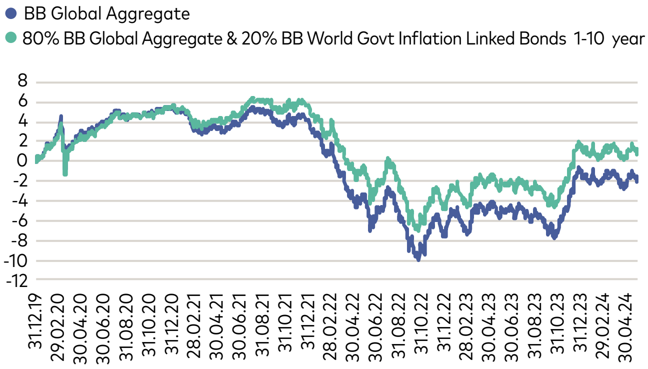
Total return hedged USD



Source: LGT Capital Partners, Bloomberg

In a portfolio context, this means that the inclusion of linkers, particularly with maturities of 1–10 years, resulted in better returns in recent years. For example, an index with an addition of 20% linkers 1–10 years into a broad fixed income portfolio, such as the Bloomberg Global Aggregate Hedged USD Index, showed a relative outperformance of almost 3%, as outlined in chart 2. In contrast, the total return of the Bloomberg World Government Inflation-Linked All Maturity Hedged USD Index performed negatively, with significantly higher volatility, but still outperformed the nominal bond portfolio.

Total return hedged USD



Source: LGT Capital Partners, Bloomberg

It is important to acknowledge that linkers have great potential to outperform in the long term. They do not provide protection over short-term horizons, as they are exposed to interest rate risk in the same way as conventional bonds. The impact of the movements in real yields can outweigh their inflation-linked income over shorter investment periods, especially the long-duration approach as demonstrated above.

Conclusion

Among all liquid investable assets globally, those that perform well when inflation rises (e.g. linkers, commodities or credit) are the scarcest. Of these, only inflation-linked bonds can perform well when economic growth is weak.

Moreover, inflation-linked bonds are preferable to other inflation hedges because they are directly linked to the official inflation rate rather than showing a looser economic connection to inflation. Linkers can therefore be a desirable addition to almost any investment portfolio. Their inclusion in portfolios can improve diversification and strengthen the risk-return ratio.

Inflation-linked bonds have again been tested in the recent economic cycle in an environment marked by significant inflation and weak economic growth and they have performed in line with expectations. Investors with linkers in their overall asset allocation have benefitted from the inflation hedge and have subsequently experienced a materially better overall performance in the context of an overall global aggregate fixed income portfolio with a conservative interest rate approach.

Long-term investors should consider inflation scenarios in their investment decisions and address the related uncertainty by adding inflation-linked bonds to their portfolio, carefully considering their sensitivity to interest rates.

Our approach to inflation-linked bonds

LGT Capital Partners has been actively investing in inflation-linked bonds since 2001. Our investment team has more than 20 years of experience in managing this asset class.

Our approach is defined using fundamental analysis, with our investment process being guided by a solid quantitative and qualitative assessment. This is the basis on which we carefully reach investment decisions for our clients.

Our active investment approach includes ESG analysis throughout the investment process and this is a central component of how we approach investments. We closely monitor issuers based on their financial and non-financial performance, risk [exposures] and ESG approach.

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